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### Key Takeaways

- The Bloomberg US High Yield 2% Issuer Cap Index returned 1.31% in the fourth quarter.
- Spreads tightened by 1 bp in the fourth quarter to 266 bps and the YTW decreased to 6.53%.
- Both BB and B rated bonds outperformed the index, returning 1.58% and 1.51%, respectively, while CCC rated bonds returned 0.18%.
- High-yield issuance totaled \$65.4 billion for the quarter (46% lower QoQ), bringing YTD issuance to \$332 billion (15% higher YoY).
- High-yield funds saw inflows of \$1.9 billion for the quarter, bringing YTD flows to \$18.3 billion (compared to inflows of \$16.4 billion for the same period a year ago).
- We are still seeing opportunities in rising-star candidates and will selectively utilize the robust primary market at attractive concessions.
- We maintain a deep cyclical bias given the yield pickup versus noncyclicals and the strong fundamentals we are seeing there, along with key overweights to airlines, cruise lines, copper producers and midstream companies within the energy sector.

### Market Review

Fixed-income market volatility persisted in the fourth quarter of 2025 as investors and policymakers navigated mixed economic signals. The longest US government shutdown, which restricted data availability, ended in November after 43 days. The US Treasury (UST) yield curve steepened, with short and intermediate UST yields finishing the quarter lower, while long-term yields increased. Equities performed well, with the S&P 500 Index reaching new highs, while credit spreads were mixed.

Total nonfarm payrolls rose by 64,000 in November, significantly higher than the -105,000 jobs reported in October. The unemployment rate also rose to 4.6% in November, up from 4.4% in September. Inflation data continued to moderate in November, with headline Consumer Price Index (CPI) falling to 2.7% year-over-year (compared to 3.0% in September) and core CPI falling to 2.6% (from 3.0% in September).

The Federal Open Market Committee (FOMC) cut the Federal Reserve (Fed) policy rate twice over the quarter, by 25 basis points (bps) to a target range of 3.50% to 3.75%. In December, the committee added language to its statement linking “the extent and timing” of further policy actions to incoming data and the evolving outlook. The Fed also resumed reserve purchases to provide for ample liquidity and smoother policy transmission.

Within the high-yield market, spreads tightened by 1 bp to end the fourth quarter at 266 bps, based on the Bloomberg US High Yield - 2% Issuer Cap USD Unhedged Index. The yield-to-worst of the index decreased to 6.53%. Both BBs and single B rated bonds outperformed the index, returning 1.58% and 1.51%, respectively, while CCC rated bonds returned 0.18%. The broad index returned 1.31% during the period. The top-performing industries were natural gas, consumer noncyclicals and banking, while technology, transportation and capital goods were the weakest performing subsectors. High-yield issuance totaled \$65 billion for

the quarter, bringing year-to-date (YTD) issuance to \$332 billion (15% higher year-over-year). High-yield funds saw inflows of \$1.9 billion for the quarter, bringing YTD flows to \$18.3 billion (compared to inflows of \$16.4 billion for the same period a year ago), according to JPMorgan.

### Outlook

Western Asset’s outlook remains constructive, though we recognize that growth momentum is tempered by uncertainty in areas such as geopolitics and fiscal sustainability.

US financial conditions are largely supportive, which, alongside proposed fiscal loosening and solid household balance sheets, points toward a positive foundation for growth in 2026. Headwinds remain, including doubts over the state of the US labor market, core inflation lingering above target and the potential lagged impact of tariffs. Having cut rates at three successive meetings since September, the Fed may now moderate its pace of easing and await further signals from the post-shutdown data releases. Fiscal vulnerabilities and persistent inflation may see the yield curve steepen further.

While fundamentals remain positive, spreads are at the tight end of historical ranges in many sectors and warrant caution. We will continue to look for further periods of volatility to add to spread risk.

An actively managed high-yield strategy yielding north of 7.25% with an option-adjusted spread of approximately 340 bps above the riskless rate remains attractive compared to equities and other higher-volatility alternatives given the current macro backdrop and sound credit fundamentals. Today’s spreads offer an ample premium in excess of

default risk, with our expectations for default rates to track around 4% on an issuer-count basis and 2% on a par-weighted basis. Leverage and interest coverage ratios for high-yield issuers have shown resilience, with healthy balance sheets and conservative management team behavior evident. From a technical perspective, we expect continued demand to persist from both institutional and retail investors as they search for steady income generation in their portfolios. A significant increase in M&A activity has provided additional tailwinds for the asset class and should continue to benefit high-yield issuers as scale is created and/or takeouts by investment-grade credits lead to material spread compression. Importantly, with an extremely robust primary calendar clearing YTD, over

70% of that deal flow has been for refinancing purposes addressing near-term maturity walls. We have and will continue to selectively utilize the primary market at attractive concessions. In terms of subsector positioning, we maintain a deep cyclicals bias given the yield pickup versus noncyclicals and the strong fundamentals we are seeing there, along with key overweights to cruise lines, airlines, copper producers and midstream companies within the energy sector.

## Risk Disclosures

All investments involve risks, including possible loss of principal. Fixed-income securities involve interest rate, credit, inflation, and reinvestment risks; and possible loss of principal. As interest rates rise, the value of fixed-income securities falls. International investments are subject to special risks, including currency fluctuations and social, economic and political uncertainties, which could increase volatility. These risks are magnified in emerging markets. Asset-backed, mortgage-backed or mortgage-related securities are subject to prepayment and extension risks. High yield bonds are subject to greater price volatility, liquidity, and possibility of default.

The **Bloomberg US High Yield 2% Constrained Index** is a component of the U.S. Corporate High-Yield Bond Index, which covers the universe of fixed-rate, non-investment-grade corporate debt of issuers in non-emerging market countries. It is not market capitalization-weighted; each issuer is capped at 2% of the index.

**Bloomberg US High Yield—2% Issuer Cap USD Unhedged Index** is an issuer-constrained version of the flagship US Corporate High Yield Index, which measures the USD-denominated, high yield, fixed-rate corporate bond market. The index follows the same rules as the uncapped version, but limits the exposure of each issuer to 2% of the total market value and redistributes any excess market value index wide on a pro rata basis.

The **Consumer Price Index (CPI)** tracks prices for a basket of more than 80,000 goods and services.

**Credit quality** is a measure of a bond issuer's ability to repay interest and principal in a timely manner. The credit ratings discussed are based on a security's rating as provided by Standard and Poor's, Moody's Investors Service and/or Fitch Ratings, Ltd., and they typically range from AAA (highest) to D (lowest), or an equivalent and/or similar rating. The credit quality of the investments in a fund's portfolio does not apply to the stability or safety of the fund. These ratings are updated monthly and may change over time. Please note that the closed-end funds have not been rated by an independent rating agency. Investment-grade bonds are bonds that are rated Aaa, Aa, A and Baa by Moody's Investors Service and AAA, AA, A and BBB by Standard & Poor's Ratings Service, or that have an equivalent rating by a nationally recognized statistical rating organization or are determined by the manager to be of equivalent quality. A below-investment-grade bond or high-yield security has a rating of BB or lower; it pays a higher yield to compensate for its greater risk.

The **Fed Funds Rate** is the interest rate at which depository institutions trade federal funds (balances held at Federal Reserve Banks) with each other overnight.

**Gross domestic product (GDP)** is an economic statistic that measures the market value of all final goods and services produced within a country in a given period of time.

**High-yield bonds** possess greater price volatility, illiquidity and possibility of default.

Investment-grade bonds are generally rated BBB and above.

The **S&P 500 Index** is an unmanaged index of 500 stocks that is generally representative of the performance of larger companies in the U.S.

**Spread** refers to the difference between Treasury securities and non-Treasury securities of similar maturity but different credit quality.

**Summary of Economic Projections** are released by the Federal Reserve four times a year. SEP features the Federal Open Market Committee (FOMC) participants' projections for GDP growth, the unemployment rate, inflation and the appropriate policy interest rate.

**U.S. Treasuries** are direct debt obligations issued by the U.S. government and backed by its "full faith and credit." The U.S. government guarantees the principal and interest payments on U.S. Treasuries when the securities are held to maturity.

**Yield to worst (YTW)** is based on a portfolio's current holdings on one specific day, is gross of all portfolio expenses, and is calculated based on assumptions that prepayment occurs if the bond has call or put provisions and the issuer can offer a lower coupon rate based on current market rates.

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